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SUBJECT: PARAGUAY'S ITAIPU NEGOTIATIONS: RESULTS AND OUTLOOK

Classified By: CDA, a.i., Michael J. Fitzpatrick; reasons 1.4 (b) and (d).

1.(C) SUMMARY: Paraguay's lead negotiator for talks on Brazil-Paraguay's Itaipu dam -- the world's largest hydro-electric generation plant generating over 90 million megawatts-hour a year -- Ricardo Canese shared January 6 a cautiously optimistic outlook for Paraguay. Canese found Brazil surprisingly open to Paraguay's demand for a "just" price for the electricity ceded to Brazil, and indicated that a preliminary agreement on price is likely by March. If Brazil concedes on the minimum price asked by Paraguay, Paraguay could benefit from roughly 640 million USD of additional resources to boost public spending. Canese admitted Paraguay's limited leverage to influence Brazil's opposition to Paraguay's selling electricity to third countries, but hoped that President Lula's apparent affinity for President Lugo will help ease this discussion. Brazil agreed to have Paraguay's Controller audit Itaipu's debt, and Paraguay is planning to restructure its share of Itaipu's debt once the audit is completed. Brazil is facing a Paraguayan team that is clearly intent on making right the "wrongs" of the past. END SUMMARY.

THE FIGURES: PARAGUAY-BRAZIL ITAIPU RELATIONSHIP

2.(U) The highly political, often emotional, issue of "fixing the wrongs of the past" by re-negotiating Itaipu was one of President Lugo's top campaign promises. The 14 megawatts (MW) binational dam Itaipu generates over 90 million megawatts-hour (MWh) of electricity a year, equally divided between Paraguay and Brazil. Paraguay, however, consumes just 8 million MWh a year and cedes at below market price the remainder of its share (roughly 37 million MWh) to Brazil, which ends up using 82 million MWh of the total electricity generated. Excluding payments for ceded electricity, compensation is equally distributed between the two countries, with each country getting about 212 million USD in royalties, 32 million USD in administrative expenses, and 21 million USD in capitalized earnings for a total of over 250 million USD.

3.(U) Including ceded electricity, Paraguay's total annual compensation for Itaipu is 354 million USD. Paraguay earns 104 million USD a year for the 37 million MWh ceded to Brazil at a price of 2.8 USD per MWh. Itaipu's total expenses, the largest being debt service payments (interest and principal), are also equally divided between Paraguay and Brazil. Itaipu holds over 18 billion USD in debt maturing in 2023 that carries roughly 2 billion USD a year in financing charges.

THE NEGOTIATION: RESULTS AND PROSPECTS

4.(C) Paraguay's Itaipu negotiation team-leader Ricardo Canese told Econoff January 6 that Brazil's willingness to discuss a Paraguay-led agenda is a positive sign. Six weeks after assuming office in August 2008, President Lugo and his negotiation team presented Paraguay's requests on Itaipu to President Lula in Brazil. These points are: A) A "fair" price for the electricity ceded to Brazil; B) Flexibility to sell to other countries; C) Revision of Itaipu's debt; D) Joint financial management; E) Shared controller's functions; and F) Completion of pending infrastructure projects. Canese opined that in the past Paraguay lacked the credibility for Brazil to take Paraguay's demands seriously. However, now for the first time Brazil and Paraguay are discussing Itaipu as equals. Canese attributed Paraguay's gained credibility to President Lugo's political image and "budding" personal relationship with President Lula.

5.(C) Canese said the minimum price sought by Paraguay for the electricity ceded to Brazil is 20 USD per MWh. The market rates of Itaipu's electricity in Brazil, Canese remarked, are 190 USD per MWh for residential and 120 USD per MWh for industrial use. (NOTE: These rates are consistent with what Brazil's state-owned electricity distribution company ELECTROBRAS reports as of January 2009. END NOTE.) Canese stated that Argentina currently pays Paraguay about 22 USD MWh for the electricity supplied by the binational Argentina-Paraguay hydro-plant Yacyreta.

6.(C) Canese noted that Brazil is surprisingly open to Paraguay's fair-price claims, citing an apparent affinity between Presidents Lula and Lugo. Canese hoped that by the end of March, Paraguay could have a preliminary agreement about price with Brazil. (NOTE: Assuming Paraguay's minimum asking price of 20 USD per MWh is granted, Paraguay is looking at over 640 million USD of additional revenues in 2009. END NOTE.)

7.(C) Canese emphasized that Paraguay is also pursuing the option to directly sell its excess electricity in the Brazilian market using the distribution lines of Brazil's ELECTROBRAS. He explained that Paraguay is negotiating with Chile and Argentina in a similar modality. Chile would get the electricity from a northern-Argentina transmission line, and Paraguay would supply the electricity to Chile via Argentina from a southern-Argentina connection at Yacyreta. Canese said Paraguay plans to sell Chile 200 MW of power from its solely-owned Acaray hydro-plant at a net price of 67 USD per MWh.

8.(SBU) Canese was enthusiastic about the progress on the debt revision issue. Brazil agreed in late-December 2008 to have Paraguay's Controller office audit Itaipu's debt. Canese expressed his surprise at Brazil's concession, considering that even Brazil's Controller has never audited Itaipu. (NOTE: Itaipu is independently audited each year by a private accounting firm which submits the report to the Brazilian Financial Director. END NOTE.) The financial burden is equally shared, but Canese said that over 4 billion USD of the total debt was wrongfully assumed by Paraguay in the administration of Paraguay's President Gonzalez Macchi (1999-2003). Canese stated the audit would help define the correct figure, and once the amount is agreed, Paraguay would seek options to restructure the debt and lower debt service payments.

9.(C) Canese indicated that Paraguay's demand to sell to third countries its share of Itaipu's electricity is by far the most contentious and politically charged point on the negotiation agenda. Brazil's internal political discussions on this issue, according to Canese, center on fears of putting at risk Brazil's currently secured supply to meet 19 percent of its electricity demand, if Paraguay is allowed to sell to other countries. Canese reasoned that Paraguay alone has limited leverage to change Brazil's position on this issue, and can only hope to steer international opinion in favor of Paraguay. Canese confided that an acceptable outcome

in the short-term is if Brazil pays a price comparable to what Paraguay could get if it sells to other countries. He said Paraguay will remain firm in its sovereign claim to commercialize its share of Itaipu's electricity, and will continue to press Brazil on this point. He noted Paraguay plans to launch a campaign to enlist influential academic figures and recognized experts in Brazil to build support for Paraguay's demands.

DUARTE'S PARTING "GIFT" ON ITAIPU

10.(C) Canese expressed frustration with what he characterized as an emblematic example of corruption and clear attempt of the Duarte administration to "sabotage" Lugo's negotiations even before they began. A month before the April 2008 election, Duarte's government agreed to Brazil's proposal to change the administrative authorization for the use of Itaipu's strategic water reserves from an Executive Board to a Director of Operations mandate. (NOTE: The water reserves are maintained at 220 meters above sea-level, but during drought seasons it can drop 3 to 5 meters, equivalent to millions of MWh. The suspicion is that with this deal the Colorado Party's elite profited under the table. END NOTE). The agreement gives Brazil control to dispose of Itaipu's water reserves without the need for Paraguay's authorization, even though Paraguay owns half. The comparable opportunity cost of the water reserves is worth billions of USD. The issue of using and managing the reserves is an unexpected element of an already complex negotiation.

11.(C) COMMENT: Despite Brazil's long-standing unwillingness to "open-up" negotiations with Paraguay on Itaipu, Canese maintains a cautiously optimistic attitude about 2009 prospects. Lugo could have a significant amount of additional resources to boost social spending and public investments, if Canese's expectations come to fruition this year. While there are some bright spots on the horizon, the negotiations have just begun, and for some items like the freedom to commercialize, there is a long road ahead. Brazil has the capacity to successfully apply a carrot and stick negotiation strategy to influence Paraguay. Beyond a "budding" personal bond between Lugo and Lula, Paraguay ultimately lacks sufficient leverage to effect a change of policy from regional-superpower Brazil. We are likely to see more from Brazil's efforts to influence the outcome of the negotiations. One thing seems certain, however: Brazil is facing a Paraguayan team clearly intent on making right the "wrongs" of Itaipu. END COMMENT.

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